OVERVIEW

TVA is the largest public electric power system in the United States, producing nearly 153 billion kilowatt-hours (kWh) of electricity in 1997. TVA is a wholly owned corporate agency and instrumentality of the United States, established by Congress in 1933 with the objective of developing and managing the resources of the Tennessee Valley region to strengthen the regional and national economy and the national defense.

TVA is primarily a wholesaler of power. Its customers are composed of three major groups: (1) distributors, consisting of municipal and cooperative systems; (2) industries that have large or unusual loads; and (3) federal agencies. TVA's power-service area covers 80,000 square miles in the Southeastern United States, including most of Tennessee and parts of Mississippi, Kentucky, Alabama, Georgia, North Carolina and Virginia. TVA also manages the Tennessee River, the nation's fifth-largest river system, for flood control, navigation, power production, recreation and other purposes.

Unless otherwise indicated, years (1997, 1996, etc.) in this discussion refer to TVA's fiscal years ended September 30.

COMPETITION AND INDUSTRY CHALLENGES

TVA and competition

The electric power industry continues to evolve to a competitive market as indicated by the introduction of numerous proposed energy-related state and federal legislation initiatives throughout the year. In order to succeed in an environment of increased retail and wholesale competition, TVA has taken steps to maintain its position as an industry leader in providing customers with low-cost power, reliable service and universal equitable access.

Although other power suppliers, under certain circumstances, may sell power in the area where TVA's power is distributed, there are statutory provisions restricting TVA from expanding the area in which it is a source of power supply. It is not unreasonable to expect that in the event any restructuring legislation is enacted, such legislation would enable TVA and the distributors of TVA power to take part, reciprocally, in competition outside the area for which they can now be a source of electric power supply.

TVA's management continues to develop plans and strategies that will help position TVA to successfully compete in a restructured electricity market. Please see the section titled "10-Year Business Outlook."

Legislative activity

Several bills were introduced in the 105th Congress to implement customer choice for all retail electric customers in the United States. Generally, the bills provide for the abolition of exclusive service territories and allow any electric utility (or other provider of electricity) to serve another electric utility's present customers, including those of TVA and the municipal and cooperative distributors served by TVA. Although no such legislation is expected to be passed in the near term, TVA expects that similar types of bills will be introduced in the next session of Congress and will receive considerable attention. TVA supports full competition in the electric utility industry, so long as all customer classes in the TVA area can enjoy the benefits, and believes it is well-positioned to succeed in a competitive environment.

Some states have taken their own steps toward retail competition. However, the states surrounding the TVA service area have been less enthusiastic toward retail competition legislation because electric rates in these states have been lower than in other parts of the country. For those states that have introduced or enacted bills, major provisions generally include a phase-in period and recovery of stranded costs.

Environmental matters

TVA's activities are subject to various federal, state and local environmental statutes and regulations. Major areas of regulation affecting TVA's activities include air pollution control, water pollution control and management, and disposal of solid and hazardous wastes. Because TVA is a federal agency, it is subject only to those state and local environmental requirements for which Congress has waived federal agency immunity. TVA's activities may, however, be subject to other more stringent environmental requirements that affect only federal activities.

TVA continues to be an industry leader in environmental compliance. Annually, TVA incurs costs associated with environmental regulatory legislation in the operation and management of its power and non-power programs. The majority of costs and environmental issues are related to control of emissions from fossil fuel plants, impact studies on proposed projects, nuclear plant decommissioning and storage and disposal of spent nuclear fuel.

TVA has incurred and continues to incur substantial capital expenditures and operating expenses to comply with environmental requirements (see note 10).

The Environmental Protection Agency has recently initiated a rulemaking to further reduce nitrogen oxide emissions in 22 Eastern states including Kentucky, Tennessee and Alabama. Reductions from coal-fired utility units are being targeted in this rulemaking. If completed as proposed, TVA could be required to reduce emissions from its coal-fired units by more than 85 percent on a system-wide basis as early as the year 2002. The strategy for achieving such reductions has not yet been developed by the states or by TVA. However, the cost of this to TVA could be significant.

10-YEAR BUSINESS OUTLOOK

During 1997, TVA unveiled its 10-Year Business Plan with the objective of achieving a 50 percent reduction in debt, and it sets a target of reducing the total cost of power by 15 percent by 2007. These actions are deemed critical for TVA to meet the challenges of the coming restructured marketplace.

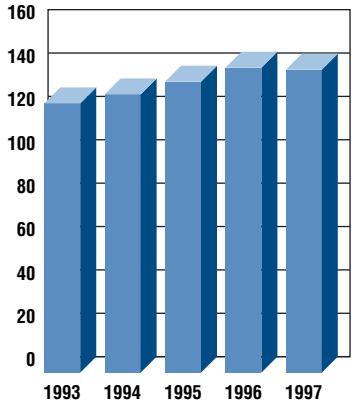
In anticipation of future challenges, TVA has already taken a number of steps, including:

- Substantially reducing the level of capital expenditures;
- Reducing employment levels and increasing the productivity of the workforce;
- Establishing a cap on debt well below the statutory ceiling authorized by Congress;
- Improving operating efficiencies of its fossil, hydro and nuclear plants to among the best in the nation; and
- Adopting an Integrated Resource Plan to comprehensively evaluate current and future energy needs and creating a TVA Strategy Team to assess future competitive conditions.

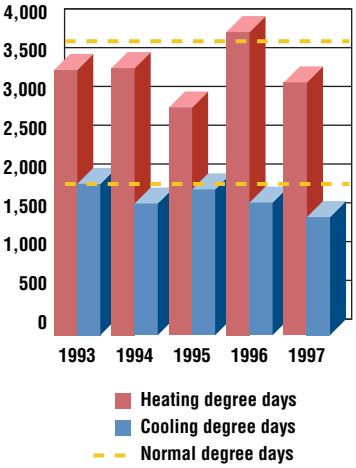
Implementation of the 10-Year Business Plan began when the Board of Directors approved an electric price increase effective October 1, 1997, which will produce a 5.5 percent increase in firm power revenues. In accordance with Board directives, all revenue from the price increase will be used for debt reduction. The 1998 price increase is expected to result in approximately $345 million of additional revenue. Capital expenditures are projected to be $732 million, down from a high of more than $2 billion in 1993. Cash flows from business operations, along with other actions recommended by the plan, are projected to generate significant funds for debt reduction.

The plan also calls for a continuation of building customer allegiance and satisfaction for a competitive environment by developing opportunities for mutual support and partnership. TVA will expand its existing manufacturing credit for large industrial customers to mitigate the price increase. The manufacturing credit is intended to have a positive effect on economic growth and therefore benefit all consumers. The plan also recommends an offer to TVA distributor customers to change their power contracts after five years from a rolling 10-year term to a rolling five-year term.

SALES OF ELECTRICITY
(billions of kWh)



WEATHER DEGREE DAYS



RESULTS OF OPERATIONS

Net income for 1997 amounted to $8 million, down from $61 million in 1996. The reduction in earnings resulted from lower operating income attributable principally to mild weather experienced within TVA's service area during the winter and summer months of 1997, partially offset by other income related to certain investment earnings.

Net income for 1996 was $61 million compared with $10 million for 1995. This improvement was primarily driven by sales growth and increased operating efficiencies.

Operating revenues

Operating revenues were $5,552 million in 1997 compared with $5,693 million in 1996. The $141 million decrease was primarily due to a decrease in energy sales to municipalities and cooperatives as a result of the cool summer and warm winter during 1997. The TVA service area experienced 17 percent lower heating degree days and 11 percent lower cooling degree days during 1997 compared with 1996. Accordingly, total kWh sales decreased 0.9 billion kWh, from 140.6 billion in 1996 to 139.7 billion in 1997.

The $318 million increase in operating revenues from 1995 to 1996 was primarily due to an increase in kWh sales of approximately six billion kWh (4.5 percent), from 134 billion in 1995 to over 140 billion in 1996. The increase in kWh sales primarily resulted from overall growth within the municipalities and cooperatives segment and more extreme weather conditions in 1996.

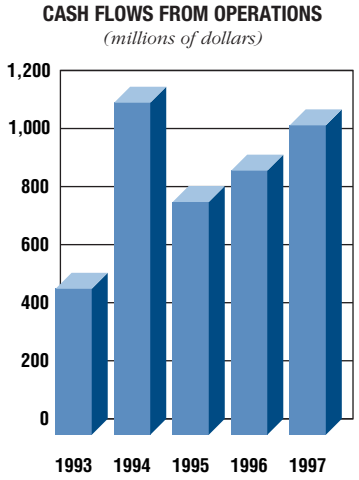
Operating expenses

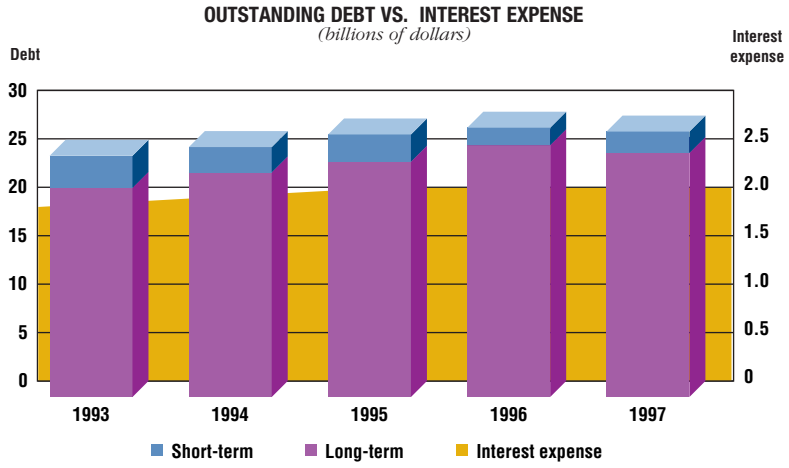
Operating expenses increased $42 million, or 1.2 percent, from $3,656 million in 1996 to $3,698 million in 1997. The operation of the Watts Bar 1 and Browns Ferry 3 nuclear units for the entire year of 1997 resulted in higher depreciation and operating expenses in 1997 as compared with 1996. These expenses, however, were partially offset by lower net fuel and purchased power expense in 1997 compared with 1996 as a result of greater generation of lower-cost nuclear power and the decrease in total power sales for the year.

Total operating expenses increased $208 million in 1996 versus 1995, or 6.0 percent, from $3,448 million to $3,656 million. The increase resulted primarily from increased generation during 1996 and the introduction of the two nuclear units to the power system. While operating and maintenance costs increased $168 million, and depreciation and amortization expenses increased $201 million, net fuel and purchased power expense declined $165 million in 1996 compared with 1995 due to favorable fuel prices and greater off-system power sales.

Other income and expenses

TVA had net other income of $157 million in 1997 compared with net other expense of $10 million in 1996 and $91 million in 1995. The 1997 net other income consisted primarily of net investment earnings of the decommissioning trust funds of $138 million. The 1995 net expense was primarily composed of a $136 million charge for the voluntary early-out package offered employees, partially offset by the recognition of an $81 million deferred gain from a 1993 sale of investments.





Interest expense

Gross interest expense remained essentially unchanged at $2,084 million in 1997 compared with $2,083 million in 1996. Total outstanding indebtedness net of unamortized discounts and other adjustments as of September 30, 1997, was $26.9 billion, with an average interest rate of 7.56 percent, compared with $27.3 billion, with an average interest rate of 7.60 percent as of September 30, 1996. The allowance for funds used during construction decreased from $117 million in 1996 to $81 million in 1997 as a result of the decline in overall construction spending.

Gross interest expense for 1996 increased $59 million compared with 1995. This increase resulted from an increase in total outstanding debt from $26.7 billion as of September 30, 1995, to $27.3 billion as of September 30, 1996. In addition, allowance for funds used during construction declined $81 million from $198 million in 1995 to $117 million in 1996.

LIQUIDITY AND CAPITAL RESOURCES

Capital structure

Prior to 1959, the U.S. Government made appropriation investments in TVA power facilities. In 1959, TVA received congressional approval to issue bonds to the public to finance its growing power program. Since that time, TVA's power program has been required to be self-supporting from revenues it produces and capital it raises in public markets. Because TVA is wholly owned by the U.S. Government, TVA does not issue equity securities. As a result, TVA raises its capital requirements through the internal generation of funds or through borrowings subject to a congressionally mandated $30 billion limit.

Like stockholders in investor-owned companies, the U.S. Government expects to earn a return on its investment. The rate of return on this investment, plus a repayment of the initial investment, is specified by law. Total repayments and return on investment by TVA to the U.S. Treasury exceed $3 billion.

Cash flows

Net cash provided by operations for 1997, 1996 and 1995 was $1,066 million, $910 million, and $802 million, respectively. This positive trend reflects continued improvements in TVA's operations during the three-year period.

Net cash used in investing activities for 1997, 1996 and 1995 was $580 million, $1,254 million and $1,871 million, respectively. These reductions reflect the decline in construction spending from $1,868 million in 1995 to $722 million in 1997.

Net cash (used in)/provided by financing activities for 1997, 1996 and 1995 was ($425) million, $530 million and $1,119 million, respectively. The cash used in financing activities during 1997 reflects the repayment of total outstanding debt of approximately $348 million, the first net reduction of debt since TVA first began issuing debt in 1961.

Capital resources

During 1997, TVA accessed the capital markets through a series of innovative financing structures designed to provide cost-effective financing for TVA and to expand its investor base. The proceeds from the 1997 borrowings were used to refinance existing debt. TVA continues to receive a bond rating of triple-A from Moody's Investors Service and from Standard and Poors rating agencies.

In December 1996, TVA reopened for the second time the 40-year bond putable in years two and 10 that was issued originally in April 1996. The bond was reopened for $350 million and priced 100 basis points below the comparable U.S. Treasury issue. This financing was noted by *Investment Dealers Digest* as one of the breakthrough deals of 1996 and as the lowest-cost funding ever achieved by a U.S. corporation.

In February 1997, TVA issued $300 million of Valley Inflation-indexed Power Securities (VIPs), the first inflation-indexed accreting principal bond offered by a U.S. corporation. The 10-year bonds have a fixed coupon rate that is paid on the inflation-adjusted principal amount and are identical in structure to the U.S. Treasury's 10-year inflation-indexed notes. TVA hedged its inflation exposure under the

VIPs through a 10-year fixed interest rate swap arrangement that provided TVA with lower-cost financing than a traditional 10-year financing.

In April 1997, TVA tapped the market for $200 million with a two-year callable bond in an issue targeted to investors in the Western United States.

In July 1997, TVA marketed an exchange offer, in which investors received the opportunity to exchange the 5.98 percent 40-year put bond for a new put bond at 5.88 percent putable in years two and nine. Over $1.2 billion of the 5.98 percent bonds were exchanged.

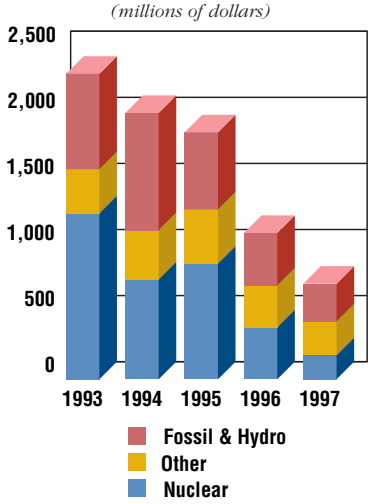
In August 1997, TVA re-entered the global market by reopening its outstanding 30-year bond issue for an additional $750 million in a deal that created what is widely regarded as the long-dated dollar benchmark in the international markets. The issue now totals $1.35 billion.

SYSTEM OPERATIONS

TVA is one of the most efficient utilities in the country, its power rates are among the lowest, and several of its power plants rank among the best performers in the industry, according to a report on the nation's top 100 utilities by *Electric Light & Power* magazine. Bringing Watts Bar and Browns Ferry nuclear units into operation was a key factor in allowing TVA to meet an all-time system peak demand of 26,670 megawatts on January 17, 1997, when the average temperature in the seven-state region was 10 degrees Fahrenheit (-12.2 degrees Celsius). For the first time ever, all of TVA's 59 fossil, five nuclear and 113 hydro units were concurrently generating power to meet the peak. TVA met the all-time demand without curtailment and was still able to help neighboring power systems meet their demands.

During 1997 TVA continued to make significant improvements in the operation of its generation and transmission systems. TVA's net winter dependable capacity was increased approximately 300 megawatts including enhancements made through the hydro-modernization efforts. TVA's nuclear capacity factor was 86 percent during 1997, near the top quartile of the industry, as compared with 85 percent during 1996. TVA's hydro equivalent availability factor also increased from 95.6 percent in 1996 to 96.4 percent in 1997 while TVA's fossil equivalent ability factor improved from 84.4 percent in 1996 to 84.6 percent in 1997. TVA also achieved a reduction in the minutes of transmission load not served—a key reliability indicator of the transmission system—declining from 9.0 minutes in 1996 to 6.7 minutes in 1997, primarily as a result of capital improvements. All of these improvements will enable TVA to continue to provide low-cost, reliable power in a competitive environment.

CONSTRUCTION EXPENDITURES
(millions of dollars)



OPERATING HIGHLIGHTS

	1996	1997
Net winter dependable capacity (megawatts)	28,123	28,417
Hydro equivalent availability factor	95.6%	96.4%
Nuclear capacity factor	85.1%	86.0%
Load not served (minutes)	9.0	6.7

FORWARD-LOOKING STATEMENTS

This Management's Discussion and Analysis and other sections of TVA's annual report contain forward-looking information that is based on current expectations, estimates and projections. The information is not a guarantee of future performance and involves risks, uncertainties and assumptions that are difficult to predict and that may cause the actual results to differ materially from the future forward-looking statements.

NON-POWER PROGRAMS

TVA's responsibilities for developing and managing public resources began with its creation in 1933. Today, these resource-management activities help sustain the interconnected tributaries and the main stem of the Tennessee River—the nation's fifth-largest river system. Multiple benefits are balanced with environmental protection to provide flood control, navigation, recreation and electric power production.

TVA's non-power programs made several significant achievements during 1997. The completion of a multi-year project for the Department of the Army at the Rocky Mountain Arsenal was a highlight of 1997. This project leveraged taxpayer funds by transferring resource-management capabilities developed by TVA to applications at federal facilities in Colorado. Another joint effort between TVA and regional and national wildlife conservation groups enabled the opening of the Elk and Bison Prairie at Land Between the Lakes. In addition to this project, the final installment of a system to significantly increase dissolved oxygen in water was completed. Essential to sustainable water quality, the water released from 17 of TVA's 113 dams now provides a dramatically improved fish habitat that will encourage the continued growth of the region's thriving recreational fishing industry.

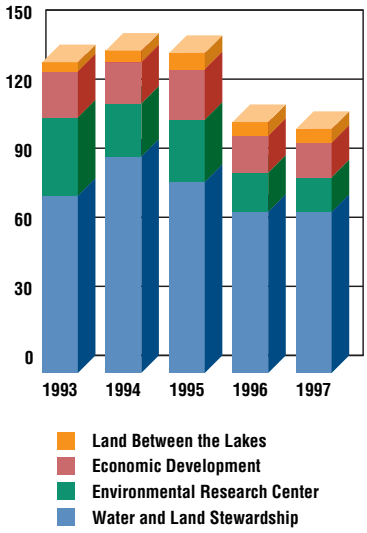
The public services on the Tennessee River are funded by federal appropriations. Additional funding of public services is possible with user fees and outside service revenues. Federal appropriations during 1997 and 1996 were $106 million and $109 million, respectively.

On October 13, 1997, the President signed an appropriations bill that (1) appropriated $70 million for non-power programs in fiscal year 1998; (2) anticipates no further appropriations to TVA thereafter; and (3) authorizes and directs TVA, beginning with October 1, 1998, to fund those non-power programs that constitute "essential stewardship

activities" principally with additional revenues to be generated by TVA. This would include using power revenues to pay for non-power activities. "Essential stewardship activities" include capital and operating costs associated with managing the Tennessee River and its tributaries for navigation, flood control, recreation, water quality and other non-power purposes and the costs of managing the shorelines and other reservoir property not already allocated to the power system. The report of the House and Senate appropriations conference committee provides that the Office of Management and Budget should review TVA's non-power functions to determine whether TVA or some other entity should be responsible for their continuation and OMB should report to Congress by February 1998.

APPROPRIATIONS

(millions of dollars)



SIGNIFICANT ACCOUNTING STANDARDS

Accounting for the effects of regulation

TVA accounts for the financial effects of regulation in accordance with Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation*. As a result, TVA records certain regulatory assets and liabilities that would not be recorded under generally accepted accounting principles for non-regulated entities.

TVA has approximately $1.9 billion of regulatory assets (see note 1—Other deferred charges and Debt issue and reacquisition costs) along with approximately $6.3 billion of deferred nuclear plants as of September 30, 1997. In the event that competition in the utility industry changes the application of SFAS No. 71, TVA would be required to evaluate such regulatory assets under the provisions of SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and Long-Lived Assets to be Disposed Of*. Statement 121 establishes requirements for evaluating and measuring asset impairments and states that regulatory assets that are no longer probable of recovery through future revenues be charged to earnings. Such an event may have an adverse effect on future results of operations from the write-off of regulatory assets. However, TVA intends to seek full recovery of any regulatory assets that may result from TVA's transition to doing business in the competitive market.

STATEMENTS OF INCOME—POWER PROGRAM

For the years ended September 30 (in millions)	1997	1996	1995
Operating revenues			
Sales of electricity			
Municipalities and cooperatives	$4,811	$4,980	$4,654
Industries directly served	464	452	460
Federal agencies	179	172	179
Other	98	89	82
Total operating revenues	**5,552**	5,693	5,375
Operating expenses			
Fuel and purchased power, net	1,211	1,278	1,443
Operating and maintenance	1,201	1,218	1,050
Depreciation and amortization	1,014	904	703
Tax-equivalents	272	256	252
Total operating expenses	**3,698**	3,656	3,448
Operating income	**1,854**	2,037	1,927
Other income (expense), net	157	(10)	(91)
Income before interest expense	2,011	2,027	1,836
Interest expense			
Interest on debt	1,993	1,965	1,908
Amortization of debt discount, issue, and reacquisition costs, net	91	118	116
Allowance for funds used during construction	(81)	(117)	(198)
Net interest expense	**2,003**	1,966	1,826
Net income	**$ 8**	$ 61	$ 10

The accompanying notes are an integral part of these financial statements.

Balance Sheets

At September 30 (in millions)	Power program		All programs	
Assets	**1997**	**1996**	**1997**	**1996**
Current assets				
Cash and cash equivalents	$ 299	$ 238	$ 374	$ 318
Accounts receivable	701	680	707	689
Inventories at average cost and other				
Fuel	112	110	112	110
Other	287	278	287	278
Total current assets	**1,399**	1,306	1,480	1,395
Property, plant, and equipment				
Completed plant	28,528	27,955	29,632	29,069
Less accumulated depreciation	(7,178)	(6,553)	(7,469)	(6,854)
Net completed plant	21,350	21,402	22,163	22,215
Construction in progress	605	744	622	764
Deferred nuclear generating units	6,303	6,293	6,303	6,293
Nuclear fuel and capital leases	1,040	1,082	1,040	1,082
Total property, plant, and equipment	**29,298**	29,521	30,128	30,354
Investment funds	**561**	440	561	440
Deferred charges and other assets				
Loans and other long-term receivables	121	319	170	375
Debt issue and reacquisition costs	1,096	1,162	1,096	1,162
Other deferred charges	1,209	1,281	1,209	1,281
Total deferred charges and other assets	**2,426**	2,762	2,475	2,818
Total assets	**$33,684**	$34,029	$34,644	$35,007

The accompanying notes are an integral part of these financial statements

Liabilities and proprietary capital	Power program 1997	Power program 1996	All programs 1997	All programs 1996
Current liabilities				
Accounts payable	$ 468	$ 392	$ 487	$ 417
Accrued liabilities	161	187	172	196
Accrued interest	499	498	499	498
Discount notes	2,151	1,774	2,151	1,774
Current maturities of long-term debt	574	2,250	574	2,250
Total current liabilities	**3,853**	5,101	3,883	5,135
Other liabilities	**1,704**	1,580	1,704	1,580
Long-term debt				
Public bonds—senior	20,354	19,403	20,354	19,403
Federal Financing Bank—senior	3,200	3,200	3,200	3,200
Public bonds—subordinated	1,100	1,100	1,100	1,100
Unamortized discount and other adjustments	(502)	(383)	(502)	(383)
Total long-term debt	**24,152**	23,320	24,152	23,320
Proprietary capital				
Appropriation investment	588	608	4,887	4,800
Retained earnings reinvested in power program	3,387	3,420	3,387	3,420
Accumulated net expense of nonpower programs	–	–	(3,369)	(3,248)
Total proprietary capital	**3,975**	4,028	4,905	4,972
Total liabilities and proprietary capital	**$33,684**	$34,029	$34, 644	$35,007

STATEMENTS OF CASH FLOWS

For the years ended September 30 (in millions)	Power program 1997	Power program 1996	Power program 1995	All programs 1997	All programs 1996	All programs 1995
Cash flows from operating activities						
Net power income	$ 8	$ 61	$ 10	$ 8	$ 61	$ 10
Net expense of nonpower programs	–	–	–	(121)	(127)	(182)
Items not requiring (providing) cash						
Depreciation and amortization	1,066	924	715	1,080	938	728
Allowance for funds used during construction	(81)	(117)	(198)	(81)	(117)	(198)
Nuclear fuel amortization	196	156	112	196	156	112
Other, net	(151)	162	72	(151)	164	142
Changes in current assets and liabilities						
Accounts receivable	(24)	(1)	(5)	(21)	7	22
Inventories and other	(19)	(22)	(8)	(19)	(22)	(8)
Accounts payable and accrued liabilities	56	(246)	74	52	(250)	(36)
Accrued interest	1	43	31	1	43	31
Other	14	(50)	(1)	14	(50)	(2)
Net cash provided by operating activities	**1,066**	910	802	958	803	619
Cash flows from investing activities						
Construction expenditures	(722)	(1,107)	(1,868)	(733)	(1,121)	(1,880)
Allowance for funds used during construction	81	117	198	81	117	198
Nuclear fuel	(159)	(76)	(77)	(159)	(76)	(77)
Proceeds from sale of investments	513	(162)	(100)	513	(162)	(100)
Purchases of investments	(483)	–	–	(483)	–	–
Proceeds from sale of loans receivable	211	–	–	211	–	–
Other, net	(21)	(26)	(24)	(13)	(13)	(39)
Net cash used in investing activities	**(580)**	(1,254)	(1,871)	(583)	(1,255)	(1,898)
Cash flows from financing activities						
Long-term debt						
Issues	3,100	4,400	3,500	3,100	4,400	3,500
Redemptions	(3,829)	(2,706)	(2,503)	(3,829)	(2,706)	(2,503)
Short-term borrowings, net	377	(1,057)	222	377	(1,057)	222
Borrowing expenses, net	(12)	(44)	(38)	(12)	(44)	(38)
Congressional appropriations	–	–	–	106	109	139
Payments to U.S. Treasury	(61)	(63)	(62)	(61)	(63)	(62)
Net cash (used in) provided by financing activities	**(425)**	530	1,119	(319)	639	1,258
Net change in cash and cash equivalents	61	186	50	56	187	(21)
Cash at beginning of period	238	52	2	318	131	152
Cash at end of period	**$ 299**	$ 238	$ 52	$ 374	$ 318	$ 131

The accompanying notes are an integral part of these financial statements.

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL—POWER PROGRAM

For the years ended September 30 (in millions)	1997	1996	1995
Retained earnings reinvested at beginning of period	$ 3,420	$ 3,402	$3,434
Net income	8	61	10
Return on appropriation investment	(41)	(43)	(42)
Retained earnings reinvested at end of period	**3,387**	3,420	3,402
Appropriation investment at beginning of period	608	628	648
Return of appropriation investment	(20)	(20)	(20)
Appropriation investment at end of period	588	608	628
Proprietary capital at end of period	**$ 3,975**	$ 4,028	$ 4,030

STATEMENTS OF NET EXPENSE—NONPOWER PROGRAMS

For the years ended September 30 (in millions)	1997	1996	1995
Water and Land Stewardship	$ 78	$ 75	$ 63
Land Between The Lakes	7	7	6
Economic Development	22	25	23
Environmental Research Center	14	20	21
Columbia Dam	–	–	69
Net expense	**$ 121**	$ 127	$ 182

STATEMENTS OF CHANGES IN PROPRIETARY CAPITAL—NONPOWER PROGRAMS

For the years ended September 30 (in millions)	1997	1996	1995
Proprietary capital at beginning of period	$ 944	$ 964	$1,007
Congressional appropriations	106	109	139
Net expense	(121)	(127)	(182)
Other, net	1	(2)	–
Proprietary capital at end of period	**$ 930**	$ 944	$ 964

The accompanying notes are an integral part of these financial statements.

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

TVA is a wholly owned corporate agency and instrumentality of the United States. It was established by the TVA Act with the objective of developing the resources of the Tennessee Valley region in order to strengthen the regional and national economy and the national defense by providing: (1) an ample supply of power within the region, (2) navigable channels and flood control for the Tennessee River System, and (3) agricultural and industrial development and improved forestry in the region. TVA carries out these regional and national responsibilities in a service area that centers on Tennessee and parts of Alabama, Georgia, Kentucky, Mississippi, North Carolina and Virginia.

TVA's programs are divided into two types of activities—the power program and the non-power programs. Substantially all TVA revenues and assets are attributable to the power program. The power program is separate and distinct from the non-power programs and is required to be self-supporting from power revenues and funds borrowed from public markets. The power program receives no congressional appropriations and is required to make annual payments to the U.S. Treasury in repayment of, and as a return on, the government's appropriation investment in TVA power facilities. Most of the funding for TVA's non-power programs has been provided by congressional appropriations. Certain nonpower activities are also funded by various revenues and user fees. Financial accounts for the power and non-power programs are kept separately.

Power rates are established by the TVA Board of Directors as authorized by the TVA Act. The TVA Act requires TVA to charge rates for power that, among other things, will produce gross revenues sufficient to provide funds for operation, maintenance and administration of its power system; payments to states in lieu of taxes; and debt service on outstanding indebtedness.

Fiscal year

Unless otherwise indicated, years (1997, 1996, etc.) refer to TVA's fiscal years ended September 30.

Revenue recognition

Revenues from power sales are recorded as service is rendered to customers. TVA accrues estimated unbilled revenues for power sales provided to customers for the period of time from the end of the billing cycle to month-end.

Property, plant, and equipment, and depreciation

Additions to plant are recorded at cost, which includes direct and indirect costs such as general engineering, a portion of corporate overhead and an allowance for funds used during construction. The cost of current repairs and minor replacements is charged to operating expense. The TVA Act requires TVA's Board of Directors to allocate the cost of completed multi-purpose projects between the power and non-power programs, subject to the approval of the President of the United States. The original cost of property retired, together with removal costs less salvage value, is charged to accumulated depreciation. Depreciation is generally computed on a straight-line basis over the estimated service lives of the various classes of assets. Depreciation expense expressed as a percentage of the average annual depreciable completed plant was 3.21 percent for 1997 and 1996 and 3.35 percent for 1995.

Decommissioning costs

During 1997 the excess of decommissioning investment earnings over the annual decommissioning provision was recorded as other income. Of the total investment earnings of $151 million, $13 million was recorded as an offset to the decommissioning provision, with the $138 million excess recorded as other income. During 1996 the annual decommissioning provision of $30 million exceeded the earnings from decommissioning fund investments of $17 million and the $13 million excess was charged to depreciation expense. During 1995, investment earnings approximated decommissioning expense and no decommissioning charges were made to depreciation expense.

Allowance for funds used during construction

The practice of capitalizing an allowance for funds used during construction is followed in the power program. The allowance is applicable to construction in progress excluding deferred nuclear generating units. In 1995, TVA changed its assumptions used in determining the interest rate used to calculate the allowance for funds used during construction. The change was made to more accurately reflect the nature of the indebtedness issued to fund construction. The effect of the change for 1995 was to increase the amount of interest capitalized by approximately $56 million.

Loans and other long-term receivables

In June 1997, TVA entered into a five-year agreement with a bank pursuant to which TVA agreed to sell certain receivables relating to TVA's consumer energy-conservation programs. As of September 30, 1997, a $211-million pool had been sold for proceeds equal to its carrying amount. In accordance with Statement of Financial Accounting Standards (SFAS) No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, the transaction has been reflected as a reduction of loans and other long-term receivables. Under the terms of the agreement, TVA has retained substantially the same risk of credit loss as if the receivables had not been sold and, accordingly, an appropriate liability account has been retained.

Other deferred charges

Deferred charges primarily include prepaid pension costs and regulatory assets capitalized under the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. At September 30, 1997, other deferred charges included total unamortized regulatory assets of $950 million—of which $468 million represents a capitalized interest component of nuclear fuel; $411 million represents a transition obligation related to the adoption of SFAS No. 112, *Employers Accounting for Postemployment Benefits*; and $71 million represents TVA's portion of the costs for decommissioning the Department of Energy's nuclear waste disposal facility. At September 30, 1996, the unamortized balances of these three regulatory assets were $595 million, $446 million and $81 million, respectively, for a total of $1,122 million. These regulatory assets are being amortized over periods ranging from eight to 15 years, generally on a straight-line basis.

Investment funds

Investment funds consist primarily of a portfolio of investments in trusts designated for funding nuclear decommissioning requirements (see note 10). These funds, at September 30, 1997, were invested in portfolios generally designed to earn returns in line with overall equity market performance.

Debt issue and reacquisition costs

Issue and reacquisition expenses, call premiums and other related costs are deferred and amortized (accreted), respectively, on a straight-line basis over the term of the related outstanding securities.

TVA has also incurred premiums related to certain advanced refundings. In accordance with regulatory practices, TVA has deferred these premiums and is amortizing them to expense ratably through the maturity dates of the new debt issues. The unamortized balances of such regulatory assets at September 30, 1997 and 1996, were $983 million and $1,042 million, respectively.

Tax-equivalents

The TVA Act requires TVA to make payments to states and local governments in which the power operations of the corporation are conducted. The basic amount is 5 percent of gross revenues from the sale of power to other than federal agencies during the preceding year, with the provision for minimum payments under certain circumstances. Cash paid for tax-equivalents for 1997, 1996 and 1995 have been $272 million, $256 million and $252 million, respectively.

Interest and capital costs

During 1997, 1996 and 1995, cash paid for interest on outstanding indebtedness (net of amount capitalized) was $1,911 million, $1,805 million and $1,678 million, respectively. In addition to paying interest on outstanding indebtedness, the TVA Act requires TVA to make annual payments to the U. S. Treasury. The annual Treasury payments represent a repayment of the original appropriation investment, along with a return on the appropriation investment. TVA paid $20 million each year for 1997, 1996 and 1995 as a repayment of the appropriation investment. TVA paid $41 million to the U.S. Treasury in 1997 as a return on the appropriation investment, while paying $43 million in 1996 and $42 million in 1995.

Risk-management activities

TVA is exposed to market risk from changes in interest rates and currency exchange rates. To manage volatility relating to these exposures, TVA has entered into various derivative transactions, principally interest rate swap agreements and foreign currency swap contracts. TVA is exposed to credit losses in the event of nonperformance by counterparties on the risk-management instruments. TVA monitors such risk and does not believe that there is a significant risk of nonperformance by any of the parties of these instruments.

Statements of cash flows

Cash and cash equivalents include the cash available in commercial bank accounts and U.S. Treasury accounts, as well as short-term securities held for the primary purpose of general liquidity. Such securities mature within three months from the date of acquisition.

Research and development costs

Expenditures related to research and development costs of new or existing products and processes are expensed as incurred. The amounts charged against income were $44 million in 1997, $45 million in 1996 and $43 million in 1995.

Insurance

TVA is primarily self-insured for property loss, workers' compensation, general liability and automotive liability. TVA is also self-insured for health care claims for eligible active and retired employees. Consulting actuaries assist TVA in determining its liability for self-insured claims. TVA maintains nuclear liability insurance with an outside party (see note 10).

Management estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the related amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2 NUCLEAR POWER PROGRAM

The nuclear power program at September 30, 1997, consisted of nine units—five operating, three deferred, and one inoperative—at four locations, with investments in property, plant and equipment as follows and in the status indicated:

(in millions)	Operating units	Installed capacity (megawatts)	Completed plant, net	Construction in progress	Deferred	Fuel investment
Browns Ferry	2	2,304	$ 3,508	$ 44	$ –	$289
Sequoyah	2	2,442	2,055	77	–	146
Watts Bar	1	1,270	6,674	34	1,716	108
Bellefonte	–	–	–	–	4,587	–
Raw materials			–	–	–	297
Total	**5**	**6,016**	**$12,237**	**$155**	**$6,303**	**$840**

Browns Ferry 3, taken off-line in March 1985 for plant modifications and regulatory improvements, was returned to service in 1996. Browns Ferry 1, also taken off-line in 1985 for modifications and improvements, will continue to remain in an inoperative status until its ultimate disposition is determined. For financial reporting purposes, the undepreciated cost of Browns Ferry 1 of $80 million is included in net completed plant and is being depreciated as part of the recoverable cost of the plant over the remaining license period.

Watts Bar 1 began operating commercially during 1996. In 1988, TVA suspended construction activities on Watts Bar 2, and the unit is currently in lay-up. Bellefonte 1 and 2 were deferred in 1988 and 1985, respectively. Estimated 1998 expenditures for the three deferred units total $9 million and are limited to lay-up, maintenance and ensuring that options remain viable.

In 1993, TVA began an integrated resource planning process to determine TVA's strategy for meeting future customer energy demands. As part of this long-term energy strategy, TVA re-evaluated the need for finishing Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. In December 1994, TVA determined it will not, by itself, complete Bellefonte 1 and 2 and Watts Bar 2 as nuclear units. In the Integrated Resource Plan (IRP), TVA determined that it would study the potential for converting the Bellefonte Nuclear Plant to a combined cycle plant utilizing natural gas or gasified coal as the primary fuel and/or joint venturing with a partner for completion. The feasibility of converting Bellefonte to such an alternate fuel will require in-depth engineering and financial analyses; and accordingly, TVA is utilizing a team of technical and financial experts. The IRP also concluded that Watts Bar 2 should remain in deferred status until completion of the Bellefonte study. The impact on TVA's financial position of completing, converting or joint venturing these units will be determined upon completion of the Bellefonte study. The future decisions on these units will ultimately impact the method of cost recovery, and the TVA Board has determined that it will, at that time, establish rate adjustments and operating policies to ensure full recovery of the cost of these units and compliance with the requirements of the TVA Act. For financial reporting purposes, the cost of the three units is presented as deferred nuclear generating units.

3 COMPLETED PLANT

Completed plant consists of the following at September 30:

(in millions)	1997			1996		
Power program	**Cost**	**Accumulated depreciation**	**Net**	**Cost**	**Accumulated depreciation**	**Net**
Fossil plants	$ 7,427	$ 2,954	$ 4,473	$ 7,320	$ 2,790	$ 4,530
Nuclear plants	14,514	2,277	12,237	14,370	1,835	12,535
Transmission	3,144	982	2,162	2,911	943	1,968
Hydro plants	1,382	471	911	1,273	454	819
Other	2,061	494	1,567	2,081	531	1,550
Total Power	**$28,528**	**$7,178**	**$21,350**	$27,955	$6,553	$21,402

4 LEASES

Certain property, plant and equipment are leased under agreements with terms ranging from one to 30 years. Most of the agreements include purchase options or renewal options that cover substantially all the economic lives of the properties. Obligations under capital lease agreements in effect at September 30 were:

Fiscal year (in millions)	**General plant capital leases**
1998	$ 36
1999	36
2000	36
2001	36
2002	36
Thereafter	301
Total future minimum lease payments	**481**
Less interest element	(280)
Present value of future minimum lease payments	**$201**

5 APPROPRIATION INVESTMENT—POWER PROGRAM

The TVA Act requires TVA to make annual payments to the U.S. Treasury from net power proceeds. The payments required by the TVA Act may be deferred under certain circumstances for not more than two years. The return is based on the appropriation investment as of the beginning of the year and the computed average interest rate payable by the U.S. Treasury on its total marketable public obligations as of the same date (6.71 percent at September 30, 1997).

6 DEBT

Borrowing authority

The TVA Act authorizes TVA to issue bonds, notes, and other evidences of indebtedness up to a total of $30 billion outstanding at any one time. TVA must meet certain cash flow and earnings tests that are contained in the TVA Act and the Basic TVA Power Bond Resolution. Debt service on these obligations, which is payable solely from TVA's net power proceeds, has precedence over the payment to the U.S. Treasury described in note 5.

Debt outstanding

Debt outstanding at September 30, 1997 and 1996 (excluding defeased debt of $950 million at September 30, 1996, which is not considered by TVA to be debt that is subject to the $30 billion bond limit), consisted of the following:

(in millions)	1997	1996
Short-term debt		
Held by the public		
Discount notes (net of discount)	$2,151	$1,774
Current maturities of long-term debt - 5.07% to 5.98%	574	2,250
Total short-term debt	2,725	4,024
Long-term debt		
Held by the public - senior		
Maturing in 1998	–	1,453
Maturing in 1999 - 5.88% to 6.58%	2,450	750
Maturing in 2000 - 8.375%	1,000	1,000
Maturing in 2001 - 6.00% to 6.50%	1,800	1,250
Maturing in years 2002 through 2045 - 6.125% to 8.625%	15,104	14,950
Held by Federal Financing Bank—senior		
Maturing in 2003 through 2016 - 8.535% to 11.695%	3,200	3,200
Held by the public- subordinated		
Maturing in 2045 through 2046 - 7.50% to 8.00%	1,100	1,100
Total long-term debt	24,654	23,703
Unamortized discount and other adjustments	(502)	(383)
Net long-term debt	24,152	23,320
Total debt	**$26,877**	$27,344

Short-term debt

The weighted average rates applicable to short-term debt outstanding in the public market as of September 30, 1997 and 1996, were 5.56 percent and 5.38 percent, respectively. During 1997, 1996 and 1995, the maximum outstanding balance of short-term borrowings held by the public was (in millions) $3,962, $3,537 and $3,503 respectively, and the average amounts (and weighted average interest rates) of such borrowings were approximately (in millions), $2,743 (5.47 percent), $2,692 (5.50 percent) and $2,743 (5.83 percent), respectively.

Put and call options

Bond issues of $12.8 billion held by the public are redeemable in whole or in part, at TVA's option, on call dates ranging from the present to April 2012 at call prices ranging from 100 percent to 106.7 percent of the principal amount. Additionally, TVA has bond issues of $2.1 billion held by the public that are redeemable in whole or in part at the option of the respective bondholders. One bond issue totaling $500 million, which matures in July 2045, is redeemable in 2001 by the bondholders. A second issue totaling $121.3 million, which matures in April 2036, is redeemable in 1998 or 2006 at the option of the bondholders and a third issue totaling $1.5 billion, which matures in April 2036, is redeemable in 1999 or 2006 at the option of the bondholders. All of these issues are reported in the debt schedule with maturity dates corresponding to the earliest redeemable dates.

Subsequent to September 30, 1997, TVA monetized the call provisions on approximately $1 billion of public bond issues. The premium received by TVA has been deferred and is being amortized over the term of the agreements.

Bond discount and premium

Discounts and premiums on power borrowings are deferred and amortized (accreted), respectively, as components of interest expense on a straight-line basis over the term of the related outstanding securities.

Foreign currency transaction and interest rate swap

During 1996, TVA entered into a currency swap contract as a hedge for a foreign currency denominated debt transaction where TVA issued 1.5 billion Deutschemark bonds, the cash flows of which were swapped for those of a U.S. dollar obligation of $1 billion. Any gain (loss) on the debt instrument due to the foreign currency transaction is offset by a loss (gain) on the swap contract. At September 30, 1997 and 1996 the currency transaction resulted in gains of $131 million and $16 million, respectively, which are included in the account "unamortized discount and other adjustments." The offsetting loss on the swap contract is recorded as a deferred liability. If any loss/gain were to be incurred as a result of the early termination of the swap contract, any resulting charge (income) would be amortized over the remaining life of the bond as a component of interest expense.

Additionally, TVA entered into a 10-year fixed rate interest swap agreement with a notional amount of $300 million. Such agreement was entered into to hedge TVA's inflation exposure related to its inflation-indexed accreting principal bonds.

7 FAIR VALUE OF FINANCIAL INSTRUMENTS

TVA uses the methods and assumptions described below to estimate the fair values of each significant class of financial instrument.

Cash and cash equivalents, and short-term debt

The carrying amount approximates fair value because of the short-term maturity of these instruments.

Investment funds

At September 30, 1997, these investments were classified as trading securities and carried at their fair value.

Loans and other long-term receivables

Fair values for these homogeneous categories of loans and receivables are estimated by determining the present value of future cash flows using the current rates at which similar loans are presently made to borrowers with similar credit ratings and for the same remaining maturities.

Bonds

Fair value of long-term debt traded in the public market is determined by multiplying the par value of the bonds by the quoted market price (asked price) nearest the balance sheet date. The fair value of other long-term debt and long-term debt held by the Federal Financing Bank is estimated by determining the present value of future cash flows using rates of financial instruments with quoted market prices of similar characteristics and the same remaining maturities.

The estimated values of TVA's financial instruments at September 30 are as follows :

	1997		1996	
(in millions)	Carrying amount	Fair amount	Carrying amount	Fair amount
Cash and cash equivalents	$ 374	$ 374	$ 318	$ 318
Investment funds	561	561	440	440
Loans and other long-term receivables	170	160	375	365
Short-term debt	2,151	2,151	1,774	1,774
Long-term debt, including current maturities	25,228	26,127	25,953	26,562

The fair market value of the financial instruments held at September 30, 1997, may not be representative of the actual gains or losses that will be recorded when these instruments mature or if they are called or presented for early redemption.

8 BENEFIT PLANS

Pension plan

TVA has a defined benefit plan for most full-time employees that provides two benefit structures, the Original Benefit Structure and the Cash Balance Benefit Structure. The plan assets are primarily stocks and bonds. TVA contributes to the plan such amounts as are agreed upon between TVA and the TVA Retirement System board of directors, which in no event would be less than the amount necessary on an actuarial basis to provide assets sufficient to meet obligations for benefits. The pension benefit for participants in the Original Benefit Structure is based on the member's years of creditable service, average base pay for the highest three consecutive years and the pension rate for the member's age and years of service, less a Social Security offset.

The Cash Balance Benefit Structure was implemented January 1, 1996. The pension benefit for participants in the Cash Balance Benefit Structure is based on credits accumulated in the member's account and member's age. A member's account receives credits each pay period equal to 6 percent of his or her straight-time earnings. The account also increases at an interest rate equal to the change in the Consumer Price Index plus 3 percent, which amounted to 5.82 percent for both 1997 and 1996. The components of pension expense for the years ended September 30 were:

(in millions)	1997	1996	1995
Pension expense:			
Service cost	$ 70	$ 72	$ 62
Interest cost on projected benefit obligation	308	309	304
Actual return on assets	(1,334)	(616)	(816)
Net amortization and deferral	899	217	450
Net pension (income) expense	**$(57)**	$(18)	$ –
Funded status:			
Actuarial present value of benefit obligations:			
Vested benefit obligation	$(3,770)	$(3,506)	$(3,256)
Nonvested benefits	(48)	(50)	(113)
Accumulated benefit obligation	(3,818)	(3,556)	(3,369)
Effects of projected future compensation	(391)	(401)	(323)
Projected benefit obligation	(4,209)	(3,957)	(3,692)
Plan assets at fair value	5,962	4,851	4,375
Excess of plan assets over projected benefit obligation	1,753	894	683
Unrecognized net gain	(1,536)	(770)	(627)
Unrecognized net obligation being amortized over 15 years beginning October 1, 1987	–	2	2
Prepaid pension cost	**$217**	$126	$58

The discount rate used to determine the actuarial present value of the projected benefit obligation was 8.0 percent in 1997 and 1996 and 7.5 percent in 1995. The assumed annual rates of increase in future compensation levels for 1997, 1996, and 1995 ranged from 3.3 to 8.3 percent. The expected long-term rate of return on plan assets was 11 percent for 1997, 1996 and 1995.

Other postretirement benefits

TVA sponsors an unfunded defined benefit postretirement plan that provides for contributions toward the cost of retirees' medical coverage. The plan covers employees who, at retirement, are age 60 and older (or who are age 50 and have at least five years of service). TVA's contributions are a flat dollar amount based upon the participants' age and years of service and certain payments toward the plan costs.

The annual assumed cost trend for covered benefits is 10.5 percent in 1997, decreasing by one-half percent per year reaching 5.0 percent in 2008 and thereafter. For 1996 and 1995, an annual trend rate of 11.0 percent and 11.5 percent, respectively, was assumed. The effect of the change in assumptions on a cost basis was not significant. Increasing the assumed health-care cost trend rates by 1 percent would increase the accumulated postretirement benefit obligation (APBO) as of September 30, 1997, by $15 million and the aggregated service and interest cost components of net periodic postretirement benefit cost for 1997 by $3 million.

The weighted average discount rate used in determining the APBO was 8.0 percent for 1997 and 1996, and 7.5 percent for 1995. Any net

unrecognized gain or loss resulting from experience different from that assumed or from changes in assumptions, in excess of 10 percent of the APBO, is amortized over the average remaining service period of active plan participants. The following sets forth the plan's funded status at September 30:

(in millions)	1997	1996	1995
Accumulated postretirement benefit obligation (APBO)			
Retirees	$220	$230	$214
Fully eligible active plan participants	2	4	1
Other active plan participants	126	187	116
APBO	**348**	421	331
Unrecognized net (loss) gain	–	(95)	(15)
Accrued postretirement benefit cost	**$348**	$326	$316
Net periodic postretirement benefit cost			
Service cost	$13	$8	$7
Interest cost	32	24	26
Amortization of loss	4	–	–
Net periodic postretirement benefit cost	**$49**	$32	$33

Other postemployment benefits

Statement of Financial Accounting Standards No. 112, *Employers Accounting for Postemployment Benefits* (SFAS No. 112), applies to postemployment benefits, including workers' compensation provided to former or inactive employees, their beneficiaries and covered dependents after employment but before retirement. Adoption of SFAS No. 112 in 1995 changed TVA's method of accounting from recognizing costs as benefits are paid to accruing the expected costs of providing these benefits. This resulted in recognition of an original transition obligation of approximately $280 million. During 1996, TVA made adjustments to certain assumptions utilized in the determination of the obligation at September 30, 1996, which resulted in an increase in the original transition obligation of approximately $194 million. In connection with the adoption of SFAS No. 112, and related approval by its Board of Directors, TVA recorded the transition obligation as a regulatory asset. The regulatory asset is being amortized over approximately 15 years, whereby the annual expense will approximate the expense that would be recorded on an as-paid basis.

Early-out and accelerated severance packages

In 1997, 1996 and 1995 TVA provided both voluntary and involuntary severance packages, which affected an aggregate of approximately 4,900 employees. During this period, severance costs totaled approximately $196 million and consisted primarily of severance pay ($150 million) and other retirement and postretirement benefits ($46 million). Also during 1997 TVA recognized a related pension curtailment gain of $27 million. The aggregate costs of the severance packages have been charged to the power program primarily as other expense during 1997, 1996 and 1995 in the amounts of $11 million, $35 million and $136 million, respectively, and the non-power program as non-power expense during 1997 and 1996 in the amounts of $8 million and $6 million, respectively.

9 MAJOR CUSTOMERS

One municipal customer accounts for approximately 9 percent of total power sales and four other municipal customers account for an additional aggregate 19 percent of total power sales. These five municipal customers purchase power from TVA under long-term contracts for terms of 20 years, which require 10-years notice to terminate.

10 CONSTRUCTION EXPENDITURES AND COMMITMENTS AND CONTINGENCIES

Construction expenditures

Construction expenditures, including capitalized interest, are estimated to be approximately $732 million for 1998 and $659 million for 1999. These estimates are revised periodically to reflect changes in economic conditions and other factors considered in their determination.

Purchase commitments

TVA has entered into approximately $2.3 billion in long-term commitments ranging in terms of up to eight years for the purchase of coal.

Contingencies

Nuclear insurance. The Price-Anderson Act sets forth an indemnification and limitation of liability plan for the U.S. nuclear industry. All Nuclear Regulatory Commission (NRC) licensees, including TVA, maintain nuclear liability insurance in the amount of $200 million for each plant with an operating license. The second level of financial protection required is the industry's retrospective assessment plan, using deferred premium charges. The maximum amount of the deferred premium for each nuclear incident is approximately $79 million per reactor, but not more than $10 million per reactor may be charged in any one year for each incident. TVA could be required to pay a maximum of $474 million per nuclear incident on the basis of its six licensed units, but it would have to pay no more than $60 million per incident in any one year.

In accordance with NRC regulations, TVA carries property and decontamination insurance of $1.06 billion at each licensed nuclear plant for the cost of stabilizing or shutting down a reactor after an accident. Some of this insurance may require the payment of retrospective premiums of up to a maximum of approximately $34 million.

Clean Air legislation. The Clean Air Act Amendments of 1990 require fossil-fuel fired generation units to reduce their sulfur dioxide and nitrogen oxide emissions in two phases in order to control acid rain. The Phase I compliance period commenced on January 1, 1995, for sulfur dioxide and January 1, 1996, for nitrogen oxide, while the Phase II compliance period commences on January 1, 2000. Based on the level of emissions, 26 of TVA's 59 operating coal-fired units are classified as Phase I units, with the remaining units being Phase II units. Compliance with these requirements has resulted in substantial expenditures for the reduction of emissions at TVA's coal-fired generating plants.

TVA's compliance strategy to reduce sulfur dioxide emissions includes the use of scrubbers at six fossil units and the use of lower-sulfur coal at the remaining 53 fossil units. TVA has completed all planned scrubbers and is on schedule to complete the change-over to lower-sulfur coal.

Nitrogen oxide reductions are required for 19 of TVA's Phase I units. These reductions were achieved through the installation of low-nitrogen-oxide burners at 13 units. TVA is in compliance with all Phase I requirements and is currently installing nitrogen oxide reduction equipment to bring TVA's remaining units in compliance with Phase II nitrogen oxide emission requirements.

Expenditures related to the Clean Air projects during 1997 and 1996 were approximately $40 million and $80 million, respectively. TVA has already completed the actions necessary to achieve Phase I compliance for both sulfur dioxide and nitrogen oxide emissions, and TVA is proceeding to take actions to comply with Phase II requirements that become effective in the year 2000 or after. The total cost of compliance cannot reasonably be determined at this time because of the uncertainties surrounding final Environmental Protection Agency regulations, resultant compliance strategy, potential for development of new emission control technologies and future amendments to the legislation.

Hazardous substances. The release and cleanup of hazardous substances are regulated under the Comprehensive Environmental Response, Compensation, and Liability Act. In a manner similar to other industries and power systems, TVA has generated or used hazardous substances over the years. TVA has been identified as a potentially responsible party with respect to three off-site disposal areas. TVA's liability at these sites has not yet been determined. In addition, TVA is currently investigating two other sites that TVA either owns or partially owns. TVA may have cleanup responsibilities at those sites by virtue of its control of the property. TVA's potential liabilities for its share of cleanup costs at these sites are uncertain but are not expected to be substantial.

Pending litigation. TVA is a party to various civil lawsuits and claims that have arisen in the ordinary course of its business. Although the outcome of pending litigation cannot be predicted with any certainty, it is the opinion of TVA counsel that the ultimate outcome should not have a material adverse effect on TVA's financial position or results of operations.

Decommissioning costs. Provision for decommissioning costs of nuclear generating units is based on the estimated cost to dismantle and decontaminate the facilities to meet NRC criteria for license termination. At September 30, 1997, the present value of the estimated future decommissioning cost of $318 million was included in other liabilities. The decommissioning cost estimates from a 1995 study are based on prompt dismantlement and removal of the plant from service. The actual decommissioning costs may vary from the estimates because of changes in the assumed dates of decommissioning, changes in regulatory requirements, changes in technology and changes in costs of labor, materials and equipment.

TVA maintains an investment trust fund to provide funding for the decommissioning of nuclear power plants. In September 1993, TVA sold the investment portfolio and realized a gain of $163 million. TVA recognized $82 million of this gain in 1994 and $81 million in 1995. During 1996, TVA took a number of related actions to establish a decommissioning fund that could reasonably be expected to provide substantially all of the funding required for decommissioning. TVA contributed an additional $123 million, and separate decommissioning trusts were established for each of TVA's nuclear plants. As of September 30, 1996, the entire fund was invested in equity market index funds.

In May 1997, TVA sold the entire $402 million equity index fund portfolio and transferred the proceeds to trust portfolios managed by independent money managers. During 1997, TVA recognized $151 million of income related to the fund, which included an $81 million gain on the sale of fund investments and $70 million in net appreciation and interest income. As of September 30, 1997, the decommissioning trust fund investments totaled $553 million and were invested in securities designed to achieve a return in line with overall equity market performance.

Cost-based regulation. As a regulated entity, TVA is subject to the provisions of SFAS No. 71, *Accounting for the Effects of Certain Types of Regulation*. Accordingly, TVA records certain assets and liabilities that result from the effects of the ratemaking process that would not be recorded under generally accepted accounting principles for non-regulated entities. Currently, the electric utility industry is predominantly regulated on a basis designed to recover the cost of providing electric power to its customers. If cost-based regulation were to be discontinued in the industry for any reason, profits could be reduced and utilities might be required to reduce their asset balances to reflect a market basis less than cost. Discontinuance of cost-based regulation would also require affected utilities to write off their associated regulatory assets. Such regulatory assets for TVA total approximately $1.9 billion at September 30, 1997, along with approximately $6.3 billion of deferred nuclear plants. Management cannot predict the potential impact, if any, of these competitive forces on TVA's future financial position and results of operations. However, TVA continues to position itself to effectively meet these challenges by maintaining prices that are locally, regionally and nationally competitive.

11 NON-POWER PROGRAMS

TVA's non-power programs provide various public services, including managing navigable river channels, providing flood control and overseeing certain recreation facilities. The non-power programs encompass general stewardship of land, water and wildlife resources. TVA's non-power programs also conduct certain research and development activities in pollution prevention and remediation.

Funding for the non-power programs is primarily provided through federal appropriations. During 1997 and 1996, the non-power programs received appropriations of $106 million and $109 million, respectively. The 1998 appropriations bill approved $70 million for non-power programs in 1998 and anticipates no further appropriation to TVA thereafter. Certain non-power-program activities are also funded by user fees and outside services revenues. Notwithstanding the historical separation of the power and non-power programs and provisions of the TVA Act and bond covenants to the contrary, public law authorizes TVA to use power revenues to pay for non-power activities beginning in 1999.

During 1995, the non-power programs had a net expense of $182 million, which included a $69 million charge for the write-off of the Columbia Dam and Reservoir project. The Columbia Dam and Reservoir, a multi-purpose project financed by congressional appropriations, was suspended in prior years due to budget restrictions and environmental concerns. During 1995, TVA determined that the Columbia Dam would not be completed, and accordingly, the project cost was expensed.

The completed plant of the non-power programs consists of multipurpose dams and other plant. At September 30, 1997, the net completed plant balances for multipurpose dams and other plant were $700 million and $113 million, respectively. At September 30, 1996, the net completed plant balances for multipurpose dams and other plant were $705 million and $108 million, respectively.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors of the Tennessee Valley Authority

We have audited the accompanying balance sheets (power program and all programs) of the Tennessee Valley Authority as of September 30, 1997 and 1996, and the related statements of income (power program), changes in proprietary capital (power program and non-power programs), net expense (non-power programs) and cash flows (power program and all programs) for each of the three years in the period ended September 30, 1997. These financial statements are the responsibility of the Tennessee Valley Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the power program and all programs of the Tennessee Valley Authority as of September 30, 1997 and 1996, the results of operations of the power program and nonpower programs and cash flows of the power program and all programs for each of the three years in the period ended September 30, 1997, in conformity with generally accepted accounting principles.

As discussed in note 8 to the financial statements, in 1995 the Tennessee Valley Authority adopted Statement of Financial Accounting Standard No. 112, *Employers Accounting for Postemployment Benefits*.

In accordance with Government Auditing Standards, we have also issued a report, dated October 23, 1997, on our consideration of the Tennessee Valley Authority's internal controls over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts and grants.

Coopers & Lybrand L.L.P.
Knoxville, Tennessee
October 23, 1997

REPORT OF MANAGEMENT

Management is responsible for the preparation, integrity and objectivity of the financial statements of the Tennessee Valley Authority as well as all other information contained in the annual report. The financial statements have been prepared in conformity with generally accepted accounting principles applied on a consistent basis and, in some cases, reflect amounts based on the best estimates and judgments of management, giving due consideration to materiality. Financial information contained in the annual report is consistent with that in the financial statements.

The Tennessee Valley Authority maintains an adequate system of internal controls to provide reasonable assurance that transactions are executed in accordance with management's authorization, that financial statements are prepared in accordance with generally accepted accounting principles, and that the assets of the corporation are properly safeguarded. The system of internal controls is documented, evaluated, and tested on a continuing basis. No internal control system can provide absolute assurance that errors and irregularities will not occur due to the inherent limitations of the effectiveness of internal controls; however, management strives to maintain a balance, recognizing that the cost of such a system should not exceed the benefits derived. No material internal control weaknesses have been reported to management.

Coopers & Lybrand L.L.P. was engaged to audit the financial statements of the Tennessee Valley Authority and issue reports thereon. Its audits were conducted in accordance with generally accepted auditing standards. Such standards require a review of internal controls and an examination of selected transactions and other procedures sufficient to provide reasonable assurance that the financial statements neither are misleading nor contain material errors. The Report of Independent Accountants does not limit the responsibility of management for information contained in the financial statements and elsewhere in the annual report.

David N. Smith
Chief Financial Officer
and Executive Vice President of Financial Services

STATISTICAL AND FINANCIAL SUMMARIES

For the years ended September 30	1997	1996	1995	1994	1993
Sales (millions of kilowatt-hours)					
Municipalities and cooperatives	114,771	117,035	110,245	108,073	105,566
Industries directly served	17,359	16,599	16,684	15,792	16,196
Federal agencies	7,567	6,966	7,226	4,407	2,382
Total sales	**139,697**	140,600	134,155	128,272	124,144
Operating revenues (millions of dollars)					
Electric					
Municipalities and cooperatives	$ 4,811	$ 4,980	$4,654	$4,582	$4,479
Industries directly served	464	452	460	452	472
Federal agencies	179	172	179	296	254
Other	98	89	82	71	71
Total revenues	**$5,552**	$5,693	$5,375	$5,401	$5,276
Revenue per kilowatt-hour (cents)[a]	**3.90**	3.99	3.94	4.03	4.06
Winter net dependable generating capacity (megawatts)					
Hydro[b]	5,384	5,298	5,225	5,242	4,885
Fossil	15,014	15,012	15,032	15,032	15,088
Nuclear units in service	5,625	5,545	3,342	3,342	3,365
Combustion turbine	2,394	2,268	2,232	2,264	2,284
Total capacity	**28,417**	28,123	25,831	25,880	25,622
System peak load (megawatts)—summer	**26,661**	25,376	25,496	23,398	23,878
System peak load (megawatts)—winter	**26,670**	25,995	24,676	24,723	21,666
Percent gross generation by fuel source					
Fossil	**61%**	65%	71%	72%	77%
Hydro	**11%**	11%	12%	14%	13%
Nuclear	**28%**	24%	17%	14%	10%
Fuel cost per kilowatt-hour (cents)					
Fossil	**1.23**	1.23	1.26	1.34	1.27
Nuclear[c]	**.58**	.56	.61	1.10	1.09
Aggregate fuel cost per kwh net thermal generation	**1.04**	1.06	1.14	1.31	1.25
Fuel data					
Net thermal generation (millions of kilowatt-hours)	**135,735**	131,898	118,097	110,643	109,968
Billion Btu	**1,381,837**	1,338,157	1,197,295	1,120,868	1,105,395
Fuel expense (millions of dollars)	**1,406**	1,395	1,348	1,450	1,375
Cost per million Btu (cents)	**101.73**	104.22	112.61	129.40	124.42
Net heat rate, fossil only	**10,180**	10,145	10,138	10,131	10,052

a Excludes Department of Energy settlement payment of $160 million for the years 1993-1994.
b Includes 405 megawatts of dependable capacity from the Corps of Engineers projects on the Cumberland River System.
c TVA changed its method of expensing the interest component of nuclear fuel expense in 1995.

Tennessee Valley Authority • 400 West Summit Hill Drive • Knoxville, Tennessee 37902
125M-11/97
Portable Document Format (PDF) version